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J. Dean Morgan

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SECTIONS 175 AND 182: FARMERS' DEDUCTIONS FOR CAPITAL IMPROVEMENTS TO LAND

Taxpayers may not generally deduct expenditures for permanent improvements to land.¹ Such expenditures must usually be depreciated or added to the taxpayer's basis of the land.² Sections 175 and 182 of the Internal Revenue Code of 1954, however, give farmers an exceptional opportunity to deduct some types of land improvement expenditures.³ As with most special benefit statutes,⁴ these sections are narrowly restricted in the scope of their application. To be deductible under section 175, an expenditure must be incurred on *land used in farming* for the purpose of *soil and water conservation* by a taxpayer engaged in the *business of farming*.⁵ Even after each of these requirements is satisfied, the deduction is subject to a ceiling of 25 percent of *gross income derived from farming*.⁶ Section 182, which applies to expenditures for the clearing of land, is likewise narrowly circumscribed.⁷

The purpose of this comment is to examine several distinct problems which may arise in claiming these types of deductions. Except for the discussion of 25 percent of income derived from farming, primary emphasis will be given to the limiting phrases of section 175, with some attention being devoted to those portions of section

¹ INT. REV. CODE OF 1954, § 263(a)(1); *Beltzer v. United States*, 59-2 U.S. Tax Cas. ¶ 9701 (D. Neb. 1959); *Winfield A. Coffin*, 41 T.C. 83 (1963); *Gifford A. Cochran*, 14 CCH Tax Ct. Mem. 206 (1955).

² *Algernon Blair, Inc.*, 29 T.C. 1205 (1958); *Thompson & Folger Co.*, 17 T.C. 722 (1951); Rev. Rul. 265, 1965-2 Cum. BULL. 52.

³ Section 180 of the Internal Revenue Code of 1954 allows the deduction of certain capital expenditures for fertilizer. It contains no problems not contained in sections 175 and 182. See Treas. Reg. § 1.180-1(a)-(b) (1961); Note, *Taxation Affecting Agricultural Land Use*, 50 IOWA L. REV. 600, 604 (1965). Section 180 itself will not be discussed.

⁴ J. O'BYRNE, *FARM INCOME TAX MANUAL* 259 (3d ed. 1964) [hereinafter cited as O'BYRNE].

⁵ "A taxpayer engaged in the business of farming may treat expenditures which are paid or incurred by him during the taxable year for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." INT. REV. CODE OF 1954, § 175(a).

⁶ "The amount deductible . . . shall not exceed 25 percent of the gross income derived from farming during the taxable year. [If it does,] . . . such excess shall be deductible for succeeding taxable years in order of time" INT. REV. CODE OF 1954, § 175(b).

⁷ "A taxpayer engaged in the business of farming may elect to treat expenditures which are paid or incurred by him during the taxable year in the clearing of land for the purpose of making such land suitable for use in farming as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." INT. REV. CODE OF 1954, § 182(a). "The amount deductible . . . shall not exceed whichever of the following amounts is the lesser: (1) \$5,000, or (2) 25 percent of the taxable income derived from farming during the taxable year." INT. REV. CODE OF 1954, § 182(b).

182 which influence the construction and application of section 175. Section 182 will provide the principal subject-matter for the discussion of 25 percent of gross income derived from farming. The analysis of neither section 175 nor section 182 is intended to be exhaustive.

Land Used in Farming

The ensuing discussion pertains to the terms "land used in farming," as used in section 175, and "making . . . land suitable for use in farming," as used in section 182. First to be treated is the claim of some writers that the two sections overlap. After this claim has been refuted, there will be introduced a classification system which should serve to illuminate the line of demarcation between the two sections.

Mutual Exclusiveness

Although it has been suggested by some writers that sections 175 and 182 overlap, so that some types of expenditures could qualify for deduction under both sections,⁸ the language of the two sections compels the conclusion that they are in fact mutually exclusive. The most obvious basis for distinguishing the two sections would seem to lie in the nature of the expenditures—soil or water conservation expenditures for section 175 as against land-clearing expenditures for section 182. But unfortunately, some expenditures can qualify as deductions for both conservation and the clearing of land.⁹ Also, it is clear that the language which the two sections share cannot provide a solution. The only remaining phrases are "land used in farming"¹⁰ and "making . . . land suitable for use in farming."¹¹ It is to these two terms that one must resort for evidence of mutual exclusiveness. "Making . . . land suitable for use in farming" implies that the land is not yet suitable for such use. That which is not yet suitable for farming cannot be "used in farming," as required by section 175. Conversely, "land used in farming" is already suitable for such use. Thus, it is clear that an expenditure to make land suitable for farming cannot also qualify as an expenditure for land used in farming. The two sections are mutually exclusive.¹²

⁸ O'BYRNE 265. See *id.* at 257 (both sections 175 and 182 apply to developmental land); INTERNAL REVENUE SERVICE, U.S. TREASURY, PUB. NO. 225, FARMER'S TAX GUIDE 1967 EDITION 32 (1966) [hereinafter cited as 1967 FARMER'S TAX GUIDE] (section 175 applies to both developmental and preparatory land); cf. CALIFORNIA FARM AND RANCH LAW 495, 513 (Cal. Cont. Educ. Bar ed. 1967) [hereinafter cited as CALIF. FARM & RANCH LAW].

⁹ Compare Treas. Reg. § 1.175-2(a) (1957), with Treas. Reg. § 1.182-3(a) (1965).

¹⁰ "The term 'land used in farming' means land used (before or simultaneously with the expenditures described in paragraph (1)) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock." INT. REV. CODE OF 1954, § 175(c) (2).

¹¹ "The term 'land suitable for use in farming' means land which as a result of the activities described in paragraph (1) is suitable for use by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock." INT. REV. CODE OF 1954, § 182(c) (2).

¹² Cf. CALIF. FARM & RANCH LAW 513.

Proposed Classification Based upon Land Use

Although sections 175 and 182 are mutually exclusive, a need still exists for determining at what point the one ceases to operate and the other begins. For this purpose a classification system based upon land use is here proposed. It will be applied to the phrases "land used in farming" and "making . . . land suitable for use in farming," to situations of land use involving the other requirements of section 175, and to the regulations on newly acquired property under section 175.

A complete cycle in the use of farm land consists of three periods: (1) preparatory, (2) developmental, and (3) productive.¹³ The preparatory period is from the beginning of the farm to the time when no more preparation is needed.¹⁴ The developmental period commences when the soil is ready to receive the crop—i.e. no more preparation is needed—until it produces, for example by bearing fruit or yielding a harvest.¹⁵ The productive period extends from the time the first fruit is borne or the harvest reaped. After the harvest, the land will remain developmental if no preparation is needed between crops, or, if preparation is needed, it will revert to the preparatory period. The second cycle of land use then begins.

Application of these land use periods to the language of the two sections reveals that a deduction should be allowed under section 182 only for an expenditure on land in the initial preparatory period—i.e. the preparatory period of the first cycle. "Making . . . land suitable for use in farming" implies that the land is not yet suitable for use in farming. Therefore, it must be prepared before it can be farmed. Since "land used in farming" is already suitable for use in farming and needs no preparation, section 175 would not apply to land in the preparatory stage (with one exception hereinafter discussed),¹⁶ but to land in the developmental and productive stages.

The existing legislative and judicial authority tends to support the first-cycle limitation of section 182 to the preparatory period and of section 175 to the developmental and productive periods. Congress has indicated its intention that section 175 not apply to the preparatory period of land use.¹⁷ The courts have not as yet interpreted

¹³ 1967 FARMER'S TAX GUIDE 32; O'BYRNE 256; Note, *Taxation Affecting Agricultural Land Use*, 50 IOWA L. REV. 600, 601 (1965).

¹⁴ The end of the preparatory period should be coincident with the beginning of the developmental period. See note 15 *infra*.

¹⁵ The developmental period could be defined as beginning only when preparation is completed and seed is planted which can begin to develop. Such a definition would include the requirement of section 175 that the land be used by the taxpayer or his tenant. However, where it was found that land needed no preparation, it was still necessary to discuss separately the question of whether the land was used simultaneously by the taxpayer. Rita Behring, 32 T.C. 1256, 1260 (1959). This seems to indicate that the definition in the text, which does not include planting or any other use by the taxpayer, is the correct definition.

¹⁶ Text at note 40 *infra*.

¹⁷ S. REP. NO. 1881, 87th Cong., 2d Sess. 126 (1962). The reason given was that expenditures incurred in the preparatory period were not incurred in the business of farming. It is unlikely that this was the actual reason, however. A taxpayer was required to be in the business of farming in order

"making . . . land suitable for use in farming" in section 182, but they have applied "land used in farming" in section 175 only to land that was in the developmental period.¹⁸ The Tax Court has stated that it is reasonably clear that expenditures to prepare previously uncultivated land were not intended to be deducted under section 175.¹⁹

Application of the Proposed Classification—First Cycle

In addition to requiring that the land be used in farming, section 175 requires that it be so used "before or simultaneously with" the expenditure, and that it be so used by the taxpayer or his tenant.²⁰ It is now necessary to test these additional requirements by the proposed classification.

During the first cycle of land use under the ownership of the present taxpayer, three different combinations of circumstances could exist and determine under which section a deduction might be available. First, if the land is preparatory when purchased, and remains so until the expenditure is incurred by the taxpayer, he should not be able to use section 175 for a deduction.²¹ Second, if the land is already developmental when he buys it, but he incurs an expenditure before he, as the taxpayer, has used the land, again no deduction should be available under section 175.²² Third, if the land is both developmental and used by the taxpayer, then he has satisfied the requirements of section 175 and may deduct his expenditure.²³

It should be noted that under the second situation discussed above—where land is developmental but has not yet been used by the taxpayer—no deduction is available under section 182 because the land has passed the preparatory stage, and no deduction is available under section 175 because the land, although developmental, has not been used by this taxpayer. For how long a time neither section will apply would seem to depend upon when "use"²⁴ by the taxpayer or his tenant is found to commence. If "use" is construed to mean physical use, the time span might be lengthy, because the taxpayer might

to benefit from section 182, and yet that section was designed expressly to allow deductions in the preparatory period. 108 CONG. REC. 18,125 (1962) (remarks of Senator Williams).

¹⁸ *Herndon v. United States*, 203 F. Supp. 536 (E.D.S.C. 1962); *Eidson v. United States*, 61-2 U.S. Tax Cas. ¶ 9668 (W.D. Tex. 1961), *rev'd on other grounds*, 310 F.2d 111 (5th Cir. 1962); *Winfield A. Coffin*, 41 T.C. 83 (1963); *Rita Behring*, 32 T.C. 1256 (1959).

¹⁹ *Rita Behring*, 32 T.C. 1256, 1261 (1959) (dictum); cf. *Baker, Special Farm Tax Problems*, 111 J. ACCOUNTANCY, April 1961, at 64, 68.

²⁰ INT. REV. CODE OF 1954, § 175(c) (2).

²¹ See text at note 16 *supra*. He could, however, deduct under section 182. *Id.*

²² See *Rita Behring*, 32 T.C. 1256 (1959), where the land was vacant and needed no preparation, but the court thought that it was necessary, in addition, that the land have been used simultaneously with the expenditure by the taxpayer.

²³ Cases cited note 18 *supra*. If the land can reasonably be treated as a unit, the use of any part of it will constitute the use of all of it. *Rita Behring*, 32 T.C. 1256, 1260-61 (1959).

²⁴ INT. REV. CODE OF 1954, § 175(c) (2).

find it desirable to allow the developmental land to lie fallow.²⁵ If, however, "use" is construed as meaning "devoted to," the time span should be minimal. Perhaps an analogy can be made to those cases where depreciation is claimed on property which the taxpayer has not physically used in his business during the taxable year but which has been available for use.²⁶ In these cases the words "used . . . in the trade or business"²⁷ have been construed to mean "devoted to the trade or business," and deductions have been allowed in the absence of actual physical use. Arguably then, a deduction should be allowed under section 175 for expenditures on land that is developmental but not physically "used," because it is "devoted to" the taxpayer's business even while it lies fallow and ready for use. One serious limitation posed by the analogy, however, is that the depreciation cases have required the taxpayer to be established in his trade or business at the inception of the property's period of idleness.²⁸ Applying this limitation to a deduction under section 175, it would follow that only one who is already established in the business of farming when he acquires the developmental property could qualify for a deduction without first putting the property to use. It would also follow that a taxpayer who purchases developmental land at the same time that he becomes a professional farmer would be precluded from taking a deduction under section 175 until he in fact puts the land to physical use.

Newly Acquired Property—First Cycle

In addition to the situations discussed above, which stem from the language of the Code, the regulations introduce the concept of newly acquired property into the first cycle of land use.²⁹ An effort will be made to demonstrate that the regulations' treatment of newly acquired land is inconsistent with the limitation of section 175 to the developmental period in the first cycle and with the Code provisions requiring that the taxpayer use the land before or simultaneously with the expenditure.

The regulations allow a deduction for conservation expenditures incurred on newly acquired land if the present taxpayer continues the use of the former owner.³⁰ But there is nothing in section 175 which would indicate that continuation of use is the criterion of deductibility; rather, the proper criteria would seem to be whether the land is developmental and whether it is used before or simultaneously with the expenditure by the taxpayer or his tenant.³¹ Therefore, the regulations would seem to be erroneous in allowing the deduction where

²⁵ In one case, the land, apparently preparatory, lay for 30 years without being used. *Rita Behring*, 32 T.C. 1256 (1959).

²⁶ *Sears Oil Co. v. Commissioner*, 359 F.2d 191, 198 (2d Cir. 1966); *Dougherty v. Commissioner*, 159 F.2d 269 (4th Cir. 1946); *Kittredge v. Commissioner*, 88 F.2d 632, 634 (2d Cir. 1937); *Yellow Cab Co. v. Driscoll*, 24 F. Supp. 993, 994 (W.D. Pa. 1938); *Otis B. Kent*, 12 CCH Tax Ct. Mem. 1491, 1499 (1953).

²⁷ INT. REV. CODE OF 1954, § 167.

²⁸ *Nullex, Inc.*, 30 T.C. 769 (1958); *Hillcone Steamship Co.*, 22 CCH Tax Ct. Mem. 1096, 1109-10 (1963).

²⁹ Treas. Reg. § 1.175-4(a)(2) (1957) (3d and 4th sentences).

³⁰ *Id.* (3d sentence).

³¹ Text at notes 16, 20 *supra*.

the use of the former owner is continued but the new owner needs to prepare the land before he can use it. Similarly, allowing the deduction if the land is developmental, but before the taxpayer has himself "used" the land would seem to be erroneous. Only where the regulations deny a deduction if the taxpayer initially prepares the land so as to change the use of the former owner do they obtain a proper result,³² and even here it is clear that the denial should be broadened to include land which needs preparation though the use of the former owner is not changed.

Not only is the criterion of continuation of use invalid, but the whole concept of newly acquired property would itself appear to be of no value in interpreting section 175. The newly acquired property situation should not be confused with that discussed earlier of land that is developmental and has been used by the taxpayer before or simultaneously with the expenditure.³³ Such land has been expressly held not to be newly acquired property;³⁴ it qualifies under the general provisions of section 175 rather than under the special provisions of the regulations for newly acquired property.³⁵ Therefore, newly acquired property must consist of land that is either preparatory or that is developmental but not yet used by the taxpayer at the time of the expenditure.³⁶ The first alternative can only qualify under section 182, not under section 175,³⁷ while the second alternative is not within either section.³⁸ To attempt to bring either situation into section 175 by calling it newly acquired property would not seem proper. As to the situation where the land is developmental and "used" by the taxpayer, everything which can be accomplished by the newly acquired property provisions of the regulations can also be accomplished under the provision of section 175 without regard to the regulations.³⁹ Because the newly acquired property provisions only obscure the meaning of "land used in farming," it is recommended that they be withdrawn by the Treasury.

Application of the Classification System—Second Cycle

Section 175 will apply at all times to land which has begun its second cycle under the ownership of the present taxpayer. Section 175 requires only that land have been used in farming by the taxpayer "before" the expenditure was incurred.⁴⁰ Land now in its second cycle under the ownership of the present taxpayer must have gone through a developmental or productive period in its first cycle under his ownership. Therefore, it was used in farming "before" the second cycle, and any expenditure incurred during the second cycle is deductible under section 175, even if incurred on preparatory land.

³² Treas. Reg. § 1.175-4(a) (2) (1957) (4th sentence).

³³ Text at note 22 *supra*.

³⁴ Herndon v. United States, 203 F. Supp. 536, 537-38 (E.D.S.C. 1962); Rita Behring, 32 T.C. 1256, 1259 (1959).

³⁵ Herndon v. United States, 203 F. Supp. 536, 537-38 (E.D.S.C. 1962); Rita Behring, 32 T.C. 1256, 1259 (1959).

³⁶ See text at notes 21-23 *supra*.

³⁷ Text at note 21 *supra*.

³⁸ See text following note 23 *supra*.

³⁹ Text at note 23 *supra*.

⁴⁰ INT. REV. CODE OF 1954, § 175(c) (2).

The legislative history strengthens this conclusion. Congress has said, "The deduction for soil and water conservation expenditures is also limited to land which prior to or at the same time as the expenditures for soil or water conservation are made, *was or is* used in farming."⁴¹ Section 175 and the phrase "used in farming" apply to land in the developmental or productive stages,⁴² and the word "is" would seem to mean land which is presently developmental or productive. "Was" must, then, refer to land which was once developmental or productive but is now in the only other stage, that of preparation.

Will section 182 apply to land once developmental but now preparatory, so that it will overlap with section 175 in this situation? This construction is unlikely, for section 182 should apply only to land which is initially preparatory as to the present taxpayer. The section should exclude land which has once been developmental but which is preparatory at the time the expenditure is incurred. The types of activities which come under section 182—e.g., the removal of rocks, cutting of trees, removal of salt from the soil, the draining and filling of a swamp or marsh⁴³—are not the kinds of activities which normally occupy farmers between crops. Rather, it would seem that they are performed at the time that the land is initially prepared, and not thereafter. As a result, the words "making . . . land suitable for use in farming" relate to preparing the land for its first "use in farming," and when it has been so prepared, section 182 will no longer apply to it.⁴⁴

To summarize, it can be said that the preparatory-developmental distinction prevents overlap and gives concrete meaning to "land used in farming" and "making . . . land suitable for use in farming." It makes the line of demarcation between the two phrases a question of fact based upon the easily observable physical condition of the land. Also, in combination with the other requirements of section 175, it clarifies section 175 and exposes the invalidity of the newly acquired property provisions of the regulations promulgated under it.

Soil and Water Conservation Expenditures

Section 175 defines expenditures paid or incurred for the purpose of soil or water conservation as expenditures for the treatment or moving of earth, the construction of watercourses, earthen dams and the like, the eradication of brush, and the planting of windbreaks.⁴⁵ For example, expenditures for irrigation facilities,⁴⁶ an

⁴¹ H.R. REP. NO. 1337, 83d Cong., 2d Sess. 29 (1954) (emphasis added); S. REP. NO. 1622, 83d Cong., 2d Sess. 34 (1954) (emphasis added).

⁴² Text at note 16 *supra*.

⁴³ Treas. Reg. § 1.182-3(a) (1965).

⁴⁴ If a deduction under section 182 is available in this situation, the two sections will overlap, and the situation will constitute an exception to their mutual exclusiveness. *But compare* INT. REV. CODE OF 1954, § 175(c) (1) (B), *with* INT. REV. CODE OF 1954, § 182(d) (1) (B).

⁴⁵ INT. REV. CODE OF 1954, § 175(c) (1). The regulations use almost the same language. Treas. Reg. § 1.175-2(a) (1) (1957).

⁴⁶ Rita Behring, 32 T.C. 1256 (1959).

earthen dam,⁴⁷ leveling land⁴⁸ and planting Bermuda grass to hold the soil⁴⁹ are deductible under section 175.

The legislative purpose behind section 175 is to encourage sound conservation practices and preservation of valuable natural resources.⁵⁰ Congress thought that conservation expenditures by a farmer were of benefit to the nation as a whole, and that the nation ought to share the cost with the farmer.⁵¹

Congress has limited deductibility under section 175 to expenditures incurred on land used in farming by a taxpayer in the business of farming,⁵² and it has imposed a ceiling on deductions of 25 percent of gross income derived from farming.⁵³ These restrictions are neutral in their effect on conservation. While they exclude certain situations in which conservation could have been encouraged, they do not discourage conservation in situations to which section 175 applies.

Congress has further limited section 175 by only including expenditures for nondepreciable items;⁵⁴ expenditures for depreciable improvements to land are not deductible.⁵⁵ This restriction is not always neutral in its effect. In some cases, it works actively against the conservation of soil and water. For example, in at least one part of the country in 1954, 35 percent more water was lost when transported by earthen irrigation ditches than when transported by underground concrete pipes or by ditches lined with tile, cement or similar material.⁵⁶ Yet in 1954, and today, improvements which could save this water—i.e. improvements constructed of masonry, concrete, tile, metal or wood—are not deductible because they are depreciable.⁵⁷ In effect, the farmer has been told by Congress that if he puts in an efficient tile or cement-lined ditch, he will have to depreciate its cost over many years, but if he engages in "sound conservation practices" (and loses 35 percent of his water) by digging a simple earthen trough, he will be able to deduct all of its cost immediately (subject, of course, to a ceiling of 25 percent of his gross income

⁴⁷ Winfield A. Coffin, 41 T.C. 83 (1963).

⁴⁸ *Eidson v. United States*, 61-2 U.S. Tax Cas. ¶ 9668 (W.D. Tex. 1961), *rev'd on other grounds*, 310 F.2d 111 (5th Cir. 1962).

⁴⁹ *Herndon v. United States*, 203 F. Supp. 536 (E.D.S.C. 1962).

⁵⁰ H.R. REP. NO. 1337, 83d Cong., 2d Sess. 29 (1954); *Hearings on H.R. 8300 Before the House Comm. on Ways and Means*, 83d Cong., 1st Sess. 921, 923, 933, 946-47, 949-50, 953, 957 (1953) [hereinafter cited as 1953 *House Hearings*]; 100 CONG. REC. 3423 (1954) (remarks of Senator Milliken); *id.* at 9594 (remarks of Senator Douglas); Stocker, *How Taxes Affect the Land and Farmers*, in LAND, THE YEARBOOK OF AGRICULTURE 240, 250 (U.S. Dep't of Agriculture ed. 1958); Baker, *Tax Accounting Problems of the Farmer*, 104 J. ACCOUNTANCY, Sept. 1957, at 51, 56; Note, *Taxation Affecting Agricultural Land Use*, 50 IOWA L. REV. 600, 601 (1965).

⁵¹ 1953 *House Hearings* 921, 923, 931, 933, 934, 935, 948-50, 953.

⁵² INT. REV. CODE OF 1954, § 175(a).

⁵³ INT. REV. CODE OF 1954, § 175(b).

⁵⁴ INT. REV. CODE OF 1954, § 175(c)(1).

⁵⁵ INT. REV. CODE OF 1954, § 175(c)(1)(A); Treas. Reg. § 1.175-2(b)(1) (1957).

⁵⁶ *Hearings on H.R. 8300 Before the Senate Comm. on Finance*, 83d Cong., 2d Sess. 2114, 2345-48 (1954) [hereinafter cited as 1954 *Senate Hearings*].

⁵⁷ Treas. Reg. § 1.175-2(b)(1) (1957).

derived from farming). In this situation, section 175 is encouraging the loss of water rather than its conservation.

Other situations illustrate the same principle. Grass or vegetation used to line a gully and prevent erosion can wash out, especially in areas where rainfall is heavy, thus leaving the bare earth subject to erosion.⁵⁸ Yet the expenditure incurred to line a gully with tile, masonry or like material in order to prevent erosion is not deductible,⁵⁹ while the expenditure to line it with grass or vegetation is deductible.⁶⁰ To give another example, adapted from a recent case,⁶¹ a cement dam was constructed to replace a washed-out earthen one. The \$76,000 expenditure was not deductible under section 175⁶² but would have been had the dam been earthen.⁶³

Congress should amend section 175 to include depreciable conservation expenditures which have discouraged conservation practices, while continuing to exclude depreciable expenditures which do not discourage such practices. The question is whether a satisfactory test can be devised to separate the desirable expenditures from the undesirable ones.

A test should apply to every nondepreciable conservation method under section 175 which has as an alternative a depreciable, more efficient method of accomplishing the same conservation objective. It should also be limited to soil, even though section 175 applies to four different categories of expenditures.⁶⁴ Two of these categories are insignificant to this discussion.⁶⁵ The two remaining categories are the treatment or moving of earth and the construction of watercourses, earthen dams and the like.⁶⁶ All activities within these

⁵⁸ 1954 Senate Hearings 2345.

⁵⁹ Treas. Reg. § 1.175-2(b)(1) (1957).

⁶⁰ Treas. Reg. § 1.175-2(b)(2) (1957); cf. *Herndon v. United States*, 203 F. Supp. 536 (E.D.S.C. 1962).

⁶¹ Robert L. Hunter, 46 T.C. 477 (1966).

⁶² *Id.* at 489.

⁶³ INT. REV. CODE OF 1954, § 175(c)(1). Whether or not earthen dams are depreciable is not entirely clear. Depreciation was allowed in one case. *Ekberg v. United States*, 60-1 U.S. Tax Cas. ¶ 9332 (D.S.D. 1959), *rev'd on other grounds*, 291 F.2d 913 (8th Cir. 1961). This may have been due to a special showing that silt would clog the dam and destroy its usefulness within 10 years. Clearly, Congress must have thought that such dams were not generally depreciable when it provided for their inclusion in section 175 and yet in the next sentence excluded depreciable expenditures. INT. REV. CODE OF 1954, § 175(c)(1)-(c)(1)(A); Treas. Reg. § 1.175-2(b)(1) (1957); Treas. Reg. § 1.182-3(a)(1)(ii) (1965); see 1954 Senate Hearings 1983-84; 1953 House Hearings 929-30.

⁶⁴ INT. REV. CODE OF 1954, § 175(c)(1). It can be argued from the language of the statute that "construction of watercourses" comes within "treatment or moving of earth," so that there are three categories. However, the interpretation of the regulations is that there are four categories. Treas. Reg. § 1.175-2(a)(1) (1957).

⁶⁵ The eradication of brush is a negative, destructive act which can never be effected by an alternative depreciable method. As to the planting of windbreaks, it is hard to imagine that a depreciable plant, probably chosen because it produces income, would be more efficient than a nondepreciable plant chosen solely for its usefulness as a windbreak. While this is a possibility, it is remote.

⁶⁶ INT. REV. CODE OF 1954, § 175(c)(1).

categories involve the moving of earth; most involve digging in the soil, but one or two—construction of earthen dams and possibly terracing—involve the moving of soil in such a way as to create a structure on it. Thus, the test is this: Expenditures for depreciable conservation items should be deductible only if the expenditure is incurred to perform more efficiently a conservation function for which the soil itself could have been used.⁶⁷

One additional requirement should be added to this test. If adopted, the test will allow the deduction of an expenditure for depreciable conservation material. The nation, because its natural resources will have been enhanced by the material used by the farmer, will then be paying part of the cost of such material.⁶⁸ If the farmer should remove the material after only part of its useful life, he might be unjustly enriched and the nation would certainly have been deprived of benefits for which it had paid. Therefore, Congress should adopt a rebate procedure whereby the farmer is forced to return to the government that part of the deduction which he has not earned.⁶⁹

To summarize, depreciable expenditures should not be excluded from section 175 so as to interfere with its purposes. The materials purchased by such expenditures become a part of the land itself, and they should be made deductible. To so alter section 175 would further the use of sound conservation practices in accordance with its purposes.

Business of Farming

Sections 175 and 182 require that a taxpayer be engaged in the business of farming in order to deduct expenditures for soil or water conservation or for the clearing of land.⁷⁰ Elaborating on both statutes, the regulations provide that a taxpayer is engaged in the business of farming if he cultivates, operates or manages a farm for gain or profit, either as owner or tenant.⁷¹ If a farm landlord receives a rental based on farm production, or if he "participates to a material extent" in the operation or management of the farm, he will be con-

⁶⁷ A similar test was proposed in 1954. 1954 *Senate Hearings* 2346. The argument, however, was based only on the furtherance of conservation, not upon a realization that section 175 can controvert its own purposes. It was logically too narrow in that it was restricted to concrete, tile and masonry, as the alternative depreciable methods.

⁶⁸ See 1953 *House Hearings* 921, 923, 931, 933, 934, 935, 949-50, 953.

⁶⁹ It has also been proposed that Congress require the material to be affixed to the land so as not to be usable if removed from it. 1954 *Senate Hearings* 2346. This prevents the farmer from selling the materials for which he has claimed a deduction. It does not, however, preserve to the nation the benefits for which the deduction was given. Alternatively, it could be required that the material be irremovable from the land. But almost anything is removable with enough force, and the question would evolve into one of degree. Furthermore, if the material were irremovable, it would unreasonably restrict the future use of the land.

⁷⁰ INT. REV. CODE OF 1954, §§ 175(a), 182(a).

⁷¹ Treas. Reg. § 1.175-3 (1957); Treas. Reg. § 1.182-2 (1965). A profit motive is the first requirement for being in any business. See, e.g., R.E.L. Finley, 27 T.C. 413, 425-26 (1956), *aff'd on other grounds*, 255 F.2d 128 (10th

sidered to be in the business of farming.⁷² If he receives a fixed rental and does not participate to a material extent, he will not be considered to be in the business of farming.⁷³

Critics have charged that the regulations under sections 175 and 182 should not exclude any farm landlord. It is argued that section 175 was designed to promote conservation, and that expenditures incurred by a fixed-rental landlord are as effective for that purpose as those incurred by a production-rental landlord.⁷⁴ It is further argued that a complex body of social security cases has grown up interpreting the phrase "materially participates" as it appears in the self-employment tax statute,⁷⁵ and that to exclude the fixed-rental landlord unless he "participates to a material extent" is to engraft this whole confusing set of cases into the meaning of sections 175 and 182.⁷⁶ While these arguments have some merit, it would seem that they touch more upon what ought to be included within the statute, perhaps by amendment,⁷⁷ rather than upon the meaning of "business of farming" in its present form.

It is the purpose of this discussion to demonstrate that the regulations do correctly interpret the phrase "business of farming." The phrase is not ambiguous, and its meaning leaves little reason to hold, in the absence of special circumstances, that the farm landlord is in the business of farming.

To arrive at the inclusion of the nonparticipating, fixed-rental landlord within sections 175 and 182, the critics may have assumed that the sections require only the tenant to be in the business of farming. But both sections say, "A taxpayer engaged in the business of farming . . ."⁷⁸ may deduct certain capital expenditures. This clearly means that if the taxpayer and the person farming the land do not coincide, the taxpayer must himself be in the business of farming in order to benefit under the statutes.

Alternatively, the critics may have assumed that the owner of a farm is in the same business as his tenant. But the man whose only farm activity is to receive a fixed-rental check does not share in the risk of the enterprise, make decisions as to farm operation, or work on the land, and he should not be considered to be in the business of farming.⁷⁹

Furthermore, other landlords are not considered to be in the bus-

Cir. 1958). This discussion will assume the existence of such a motive in both landlord and tenant.

⁷² Treas. Reg. § 1.175-3 (1957); Treas. Reg. § 1.182-2 (1965).

⁷³ Regulations cited note 72 *supra*. This includes the landlord who receives a fixed cash rental and probably the one who receives a fixed crop rental as well. O'Byrne, *Reflections on Farmers' Income Taxes*, 45 ILL. B.J. 388, 397 (1957).

⁷⁴ H. HALSTEAD, *FEDERAL TAXATION OF FARMERS* 132 (1961); O'BYRNE 261; Note, *Taxation Affecting Agricultural Land Use*, 50 IOWA L. REV. 600, 604 (1965).

⁷⁵ O'BYRNE 663-85.

⁷⁶ *Id.* at 261; cf. H. HALSTEAD, *FEDERAL TAXATION OF FARMERS* 132 (1961).

⁷⁷ H. HALSTEAD, *FEDERAL TAXATION OF FARMERS* 132 (1961).

⁷⁸ INT. REV. CODE OF 1954, §§ 175(a), 182(a).

⁷⁹ See INT. REV. CODE OF 1954, § 1402(a). It "starts with the premise that rentals . . . are not self-employment income." O'BYRNE 664.

inesses of their tenants. The lessor of a grocery store would not ordinarily be considered to be in the retail food business, and the lessor of office space to an insurance company would not ordinarily be considered to be in the insurance business. There is no more persuasive reason why the lessor of a farm should be considered to be in the business of farming.

However, there may be situations in which a landlord acts not only as landlord but actually engages in the tenant's business of farming.⁸⁰ In such a case, the landlord will be considered to be in the business, not by virtue of being a landlord, but by virtue of his participation.

It would logically follow that not only a landlord, but anyone who meets the required standards of participation in the tenant's business of farming should benefit under sections 175 and 182. But to be deductible under those sections, expenditures must be incurred on land farmed by the taxpayer or his tenant.⁸¹ Consequently, if a person is otherwise eligible for the deduction but does not himself farm the land, he must be a landlord, because his tenant must be farming the land. The regulations are correct in establishing standards of participation only for landlords.

The Treasury has set up two standards of activity for the landlord which constitute participation sufficient for the business of farming.⁸² The landlord who receives rent based on the production of the farm is in the business of farming. While he does not labor on the farm, he contributes capital equal to the value of his land and shares in the entire risk of the enterprise. It seems reasonable to treat him as a quasi-partner of the tenant, and they are both in the business of farming.

The second standard requires that the fixed-rental landlord "participate to a material extent" in the operation or management of the farm.⁸³ Because the self-employment tax statute⁸⁴ is the source of the phrase "participates to a material extent,"⁸⁵ it can be argued that the Treasury intended the four tests promulgated under that statute to determine the meaning of "participates to a material extent" for purposes of sections 175 and 182. The tests provide that a farmer "materially participates" if he, *first*, does three of the following four things: advances, pays or stands good for at least half the direct costs of producing the crop; furnishes at least half the tools, equipment and livestock used in producing the crop; advises and consults with the tenant periodically; or inspects the production activities periodically; or, *second*, takes an important part in management decisions; or, *third*, works 100 hours or more over a period of 5 weeks or more in activities connected with producing the crop; or, *fourth*,

⁸⁰ See, e.g., *Celebrezze v. Benson*, 314 F.2d 219 (8th Cir. 1963); *Celebrezze v. Wifstad*, 314 F.2d 208 (8th Cir. 1963); *Conley v. Ribicoff*, 294 F.2d 190 (9th Cir. 1961).

⁸¹ INT. REV. CODE OF 1954, §§ 175(c)(2), 182(c)(2).

⁸² Treas. Reg. § 1.175-3 (1957); Treas. Reg. § 1.182-2 (1965).

⁸³ Treas. Reg. § 1.175-3 (1957); Treas. Reg. § 1.182-2 (1965).

⁸⁴ INT. REV. CODE OF 1954, § 1402(a).

⁸⁵ Lowe, *Farm Operations Offer Ideal Vehicle for a Tax-Sheltered Investment Program*, 25 J. TAXATION 235 (1966). See H. HALSTEAD, *FEDERAL TAXATION OF FARMERS* 132 (1961); O'BYRNE 261.

does things which, in their "total effect," show that he was materially involved on the farm.⁸⁶ The result is that if the landlord contributes either labor or capital in addition to the value of his land, he will be materially participating in the tenant's business of farming. Again, it seems reasonable to treat him as a quasi-partner of the tenant and therefore in the business of farming.⁸⁷

In summary, it can be said that there is little reason under sections 175 and 182 to consider the nonparticipating, fixed-rental landlord to be in the business of farming. But where the landlord participates on the farm or takes substantial risks in connection with it, it is fair to give him the benefit of the deductions for conservation and land-clearing expenditures.

25 Percent of Gross Income Derived from Farming

The total amount of soil and water conservation expenditures deductible under section 175 in any one taxable year is limited to 25 percent of gross income derived from farming.⁸⁸ If for any taxable year the amount of such expenditures exceeds 25 percent of gross income from farming, the excess may be carried over to succeeding taxable years until exhausted, subject, of course, to the 25 percent limitation in each year.⁸⁹ The total amount of expenditures deductible under section 182 in any one taxable year is limited to \$5000 or 25 percent of taxable income derived from farming, whichever is lesser.⁹⁰ Because there is no carryover provision in section 182, any part of the amount expended which exceeds the lesser of \$5000 or 25 percent of taxable income must be capitalized and added to the basis of the land.⁹¹

To use gross income in section 175 and taxable income in section 182 seems to be a needless distinction. It would be simpler and more in accord with the purposes of section 182 if the limitation were 25 percent of gross income from farming and contained a carryover provision similar to that in section 175.

Before discussing whether the limitation on section 182 should be changed to a percentage of gross income, it must be asked why it is necessary to limit the deductions under sections 175 and 182 to a percentage of either gross or taxable income. Because capital gains are taxed at lower rates than ordinary income if the taxpayer is affluent,⁹² such taxpayers could, if the sections were not restricted, improve land by making capital expenditures deductible against ordinary income and then recover the amounts expended as capital gain upon the sale of the property.⁹³ This conversion of ordinary

⁸⁶ 1967 FARMER'S TAX GUIDE 58; O'BYRNE 672-74.

⁸⁷ See cases cited note 80 *supra*.

⁸⁸ INT. REV. CODE OF 1954, § 175(b).

⁸⁹ *Id.*

⁹⁰ INT. REV. CODE OF 1954, § 182(b).

⁹¹ INT. REV. CODE OF 1954, § 263; S. REP. No. 1622, 83d Cong., 2d Sess. 33 (1954).

⁹² See INT. REV. CODE OF 1954, §§ 1201-02.

⁹³ H.R. REP. No. 1337, 83d Cong., 2d Sess. 29 (1954); 1954 Senate Hearings 1983-84; 1953 House Hearings 936-37; Stocker, *How Taxes Affect the Land and Farmers*, in LAND, THE YEARBOOK OF AGRICULTURE 240, 250 (U.S. Dep't of Ag-

income to capital gain would provide an effective method of tax avoidance.⁹⁴ In order to foil attempts to keep nonfarm income out of the high ordinary-income brackets, Congress found it necessary to "relate the expensing of capital costs to farm income"⁹⁵ by a percentage of gross farm income in the case of section 175 and by a percentage of taxable farm income in the case of section 182.

While it is desirable to limit sections 175 and 182 by a percentage of farm income, it is questionable whether the limitation of section 182 to a percentage of *taxable* income accords with the broad purposes of that section. Section 182 was not intended to give large farmers any advantage over small farmers,⁹⁶ or to bring more land into production in an already glutted market.⁹⁷ Its avowed purpose was to benefit small farmers⁹⁸ by giving them tax advantages equal to those enjoyed by large farmers in the clearing of land.⁹⁹ Congress realized that the large farmer, with a plentiful cash reserve, could buy equipment to clear his own land and charge off the cost of such equipment, while the small farmer, forced to contract for the work because of the insufficient funds to buy the equipment, would not get such a deduction.¹⁰⁰

Section 182 should apply to land in its initial preparatory period.¹⁰¹ Land in this period of its evolution will probably produce little income; yet expenses, some of which will not occur again, will probably be exceptionally heavy. As a result, the farmer will have little or no taxable income¹⁰² unless the farm shows a profit in its first year, or the taxpayer owns additional farms which are presently yielding income, or the land being prepared is an extension of

riculture ed. 1958); Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237, 259 (1967); Jamison, *Tax Planning with Livestock and Farming Operations*, U. SO. CAL. 1961 TAX INST. 583, 589.

⁹⁴ *Id.* If the taxpayer earns \$100 on which he would usually pay tax at ordinary income rates, and during the same year spends \$100 for conservation or the clearing of land, he is able to deduct the \$100 and in effect pay no tax on it for that year. Theoretically, the value of his land will have been increased \$100 by the deductible expenditure, and when the taxpayer sells the land, he should receive \$100 more for it. Usually, he will pay tax at capital gains rates on all the proceeds, including the \$100 which began as ordinary income.

⁹⁵ H.R. REP. NO. 1337, 83d Cong., 2d Sess. 29 (1954). Relating the deductions to farm income is necessary because the business of farming requirement does not prevent avoidance by conversion. The taxpayer could run a farm as a bona fide business and still maintain his principal profession. Cf. *Fackler v. Commissioner*, 133 F.2d 509 (6th Cir. 1943). Then, by spending the income from his principal profession to improve the farm, he could convert the income to capital gain.

⁹⁶ 108 CONG. REC. 18,125-27 (1962) (remarks of Senator Williams). *But see id.* at 18,740 (remarks of Senator Hickenlooper).

⁹⁷ *Id.* at 18,125-26 (remarks of Senator Williams). *But see id.* (remarks of Senator Douglas); *id.* at 18,740 (remarks of Senator Hickenlooper).

⁹⁸ *Id.* at 18,126-27 (remarks of Senator Williams).

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ Text preceding note 16 *supra*.

¹⁰² Expenses are subtracted from gross income to compute taxable income. INT. REV. CODE OF 1954, § 63.

an already developed farm.¹⁰³ All of these situations would seem to be more typical of the large farmer than the small one. This is not in accord with the avowed purposes of section 182.

If the small farmer is to be helped, limiting section 182 to a percentage of gross income derived from farming would be more effective than the present limitation based on taxable income. Because gross income is computed without subtracting any of the expenses of the farm,¹⁰⁴ the heavy expenses of the preparatory period would not reduce the amount of the allowable deduction. The owner of an income-producing farm regardless of size would be entitled to a deduction of some amount under section 182.

It might be objected that abandoning 25 percent of taxable income and adopting 25 percent of gross income would cause undue loss of revenue to the government. But the 25 percent figure appears to be arbitrary, and it could easily be adjusted downward to compensate for the fact that gross income is larger than taxable income. This would have no effect on the equality of tax advantages as between small and large farmers.

Whether or not section 182 is amended so as to be limited to a percentage of gross income, it should be amended to include a carry-over provision similar to that in section 175. A limitation based on a percentage of either gross or taxable income gives the large farmer an advantage over the small one. The large farmer's deduction has more monetary value, because he has more farm income. The carry-over provision in section 175 equalizes situations arising under that section.¹⁰⁵ The small farmer, whose lack of income prevents him from deducting all of his expenditures in the year incurred, merely deducts them in subsequent years. Although he may lose some benefit by not being able to deduct them all in the same year, he is still able to obtain the major part of his tax saving.¹⁰⁶ Because there is no similar provision in section 182, the small farmer presently loses any amount by which his land-clearing expenditures exceed 25 percent of his farm income. The large farmer would also lose any excess, but because he has more gross and taxable farm income, his ceiling will be higher, and he will have an excess less often. He will obtain the full benefit of section 182 more frequently than the small farmer.

The \$5000 maximum limitation in section 182 does not affect equality of advantage as between any two farmers until one of them attains a level of \$20,000 of taxable income.¹⁰⁷ Any farmer who

¹⁰³ RESEARCH INSTITUTE OF AMERICA, 4 TAX COORDINATOR § N-317 (1967).

¹⁰⁴ INT. REV. CODE OF 1954, § 61; Treas. Reg. § 1.61-4 (1957); cf. Treas. Reg. § 1.162-12 (1958). It has been argued that cost of goods sold might not be included in the gross income of a farmer for some purposes, under "general accounting principles." Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237, 260-62 (1967). However, exclusion of cost of goods sold from gross income would appear to be a "general accounting principle" only as to manufacturing, merchandising and mining businesses. Treas. Reg. § 1.61-3 (1957).

¹⁰⁵ Note, *Taxation Affecting Agricultural Land Use*, 50 IOWA L. REV. 600, 606 (1965).

¹⁰⁶ *Id.*

¹⁰⁷ See 108 CONG. REC. 18,127 (1962) (remarks of Senator Aiken).

attains such a level would not seem to be a small farmer,¹⁰⁸ and it is consistent with the purpose of the statute to limit his deduction to \$5000.

To summarize, it can be said that section 182 should be amended so as to be limited by a percentage of gross, rather than taxable, income derived from farming. This would eliminate a needless distinction between section 175 and section 182 and would accord more fully with the purposes of the latter. In addition, section 182 should be amended to include a carryover provision such as that found in section 175.

*J. Dean Morgan**

¹⁰⁸ *Id.* (remarks of Senator Williams).

* Member, Third Year Class.